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2021 EU-wide stress test: Frequently Asked Questions

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Key features of the 2021 EU-wide stress test exercise

1. What is the objective of the EU-wide stress test?

The EU-wide stress test is part of the supervisory toolkit used by Competent Authorities (CAs) to assess the resilience of EU banks to relevant shocks, identify residual areas of uncertainties, as well as feed into the supervisory decision-making process to determine appropriate mitigation actions. The stress test also allows CAs to assess if banks' capital, which have been accumulated in recent years, is sufficient to cover losses and support the economy in stressed times. Moreover, the exercise fosters market discipline through the publication of consistent and granular data on a bank-by-bank level, which illustrate how balance sheets are affected by common shocks.

This year, given the specific macroeconomic conditions caused by the COVID-19 pandemics coupled with a high degree of uncertainty that follows, the focus on the different objectives will depend on the conditions closer to the publication.

In addition, the outcome might serve as valuable input for identifying possible exit strategies from the flexibility measures granted to banks, due to the COVID-19 crisis, or for considering additional measures, should the current economic conditions deteriorate further.

2. How does the stress test work in practice?

The EU-wide stress test is a bottom-up exercise. The EBA develops a common methodology, which is applied by all banks using their internal models. Methodological constraints in several areas limit banks' degrees of freedom and ensure a level playing field and comparability of the outcomes. Banks' results are checked and quality assured by CAs. The common methodology allows CAs to undertake a rigorous assessment of banks' resilience under stress in a common and comparable way.

3. What is the role of the EBA?

The EU-wide stress test is initiated and coordinated by the EBA and undertaken in cooperation with CAs (including the Single Supervisory Mechanism (SSM) for the euro area banks), the European

Central Bank (ECB) and the European Systemic Risk Board (ESRB). The EBA is responsible for coordinating the exercise and for developing a common methodology. The EBA supports the quality assurance process by providing common quality assurance guidelines and EU-wide descriptive statistics on the main risk parameters to enable CAs to perform consistency checks and to allow them to undertake a rigorous assessment of banks' results. In addition, the EBA acts as a data hub for the final dissemination of the outcome of the exercise, thus ensuring transparent and comparable disclosure of banks' results. Finally, the EBA plays a key role in ensuring effective communication and coordination between home and host authorities in the framework of colleges of supervisors.

4. What are the roles of other ECB, ESRB, the national Competent Authorities and the Single Supervisory Mechanism?

The ESRB, in close cooperation with the ECB, CAs, the EBA and national central banks, are responsible for designing both the baseline and adverse macroeconomic scenarios. The baseline for EU countries is based on the December 2020 projections from the national central banks¹, while the adverse scenario is developed by the ESRB's Task Force on Stress Testing and is approved by the ESRB General Board.

CAs, including the SSM, are responsible for ensuring that banks correctly apply the common methodology developed by the EBA. In particular, CAs and the SSM are responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. Furthermore, they are responsible for determining the resulting supervisory actions.

5. Which banks are involved in the exercise?

The 2021 exercise covers a sample of 50 banks - 38 from SSM countries - representing about 70% of EU banks' total assets. In comparison with previous EU-wide stress tests, UK banks are no longer in the sample following the UK's withdrawal from the EU. The EU-wide stress test is conducted at the highest level of consolidation (group level).

6. What is the timeline for the stress test?

After the launch of the exercise, banks will estimate the impact of the adverse scenario on their balance sheets and will provide several submissions of the stress test results to CAs and the EBA. These submissions are quality assured and challenged by the CAs. The EBA expects to publish the results of the exercise by 31 July 2021.

Key Methodological Features

7. What are the specificities and key features of the 2021 EU-wide stress test exercise?

¹ For non-EU countries, the baseline is based mainly on the projections from the October 2020 IMF World Economic Outlook and on the projections of ECB staff based on October 2020 data from the OECD.

The exercise will be similar to the previous ones and will be based on a bottom-up projection from banks subject to constraints and a static balance sheet approach.

The methodology has remained broadly similar to the postponed 2020 stress test exercise methodology. However, the support measures deployed in response to the COVID-19 pandemic have required some changes to the methodology. This year's methodology clarifies the treatment of COVID-19 EBA-compliant moratoria and COVID-19 public sector guarantees. In particular, moratoria should not be considered in banks' projections, while maturing loans guaranteed by COVID-19 public sector guarantees should always be replaced with the guarantee for calculating the projections. Additional information will also be collected on exposures benefiting from COVID-19 moratoria and public guarantee schemes for public disclosure and to support quality assurance. Also connected to COVID-19 pandemic, the 2021 methodology reflects the amendments to the capital requirements regulation that were published in the Official Journal ([the 'CRR Quick Fix'](#)) in June 2020. In addition, some specific changes have been introduced to recognise FX variations for certain P&L items.

In line with what was planned for the postponed 2020 exercise, in the 2021 EU-wide stress test the transparency templates provide information on Pillar 2 Requirements (P2R) for each bank at the starting point, i.e. December 2020.

8. How will the EBA ensure consistency between both Eurozone and non-Eurozone countries in the conduct of the exercise?

The exercise is conducted across the EU. Therefore, its consistency relies on the common methodology, same scenario, and a rigorous assessment of the granular transparency of results and underlying data. In addition, the EBA will conduct a comparative analysis at the end of the quality assurance process run by CAs. The bank results will also be discussed in the framework of colleges of supervisors involving home and host authorities, as well as the EBA.

Stress Test Scenarios

9. How is this year's scenario different compared to the previous exercises?

Similar to the previous exercises, the narrative of the adverse scenario for the EU-wide banking stress test reflects the main risks for EU banks that have been identified by the EBA and the ESRB. However, this time the narrative depicts an adverse scenario related to the ongoing concerns about the possible evolution of the COVID-19 pandemic. Such a downturn scenario would be characterised by a strong drop in confidence leading to a prolongation of the worldwide economic contraction.² The worsening of economic prospects is reflected in a global decline of long-term risk-free rates from an already historically low level and results in a sustained drop in GDP and an increase of unemployment. Slowing growth momentum would cause a drop in corporate earnings

² These confidence shocks could be triggered by a mutation of the virus, significant setbacks in the distribution or acceptance of vaccines, possible further lockdowns following re-emerging waves of infections and/or other unexpected negative developments in the containment of the pandemic.

leading, together with a re-assessment of market participants' expectations, to an abrupt and sizeable adjustment of financial asset valuations as well as a significant drop in real estate prices. A decline in economic growth and rising risk *premia* could further challenge debt sustainability in the public and private sectors across the EU.

10. What are the key features of the adverse scenario?

The banks have to apply the adverse scenario defined as a combined result of, *inter alia*, foreign demand shocks, financial shocks and domestic demand shocks in the EU. The most important shocks of the adverse scenario would lead to:

- a decline in EU real GDP by 3.6% from 2020 to 2023, due to a long-lasting recession;
- an increase in the EU unemployment rate of 4.7 percentage points within the same period;
- a falling Harmonised Index of Consumer Prices (HICP) in the EU, with the adverse level being 1.5% lower than the baseline level in 2023;
- a decrease in residential property prices by 21.9% below the baseline level by 2023, which corresponds to a cumulative fall in residential property prices over the scenario horizon by 16.1% at the EU aggregate level. The cumulative fall of commercial real estate prices from the starting point amounts to 31.2% for the EU due to a stronger impact of COVID-19 on the commercial real estate sector (home office and non-financial corporate insolvencies).
- an increase of long term rates by 53 bps in aggregate EU terms at the 3 year horizon, while the equities drop in the first year by 50% for Europe and the Developed World.

The convention used in the calibration of adverse scenarios for the 2021 EU-wide stress tests is one of “no policy change”. This means that neither monetary policy nor fiscal policy reactions are assumed under the adverse scenario over and above what is already embedded in the baseline scenario.

11. How severe is the adverse scenario, compared to the previous exercises?

The 2021 adverse scenario is very severe having in mind the weaker macroeconomic starting point in 2020 as a result of the severe pandemic-induced recession. The severity of the scenario reflects a stage of the financial cycle after the COVID-19 crisis, which naturally means that the scenario is less severe than the one designed for the postponed 2020 exercise, when the downturn had not yet occurred.

The design of the scenario has also taken into consideration some of the proposals made in the 2019 report by the European Court of Auditors. In particular, the 2021 stress test scenario is based on a more explicit link between the scenario design and the systemic risk assessments of the ESRB, the ECB and the EBA.

In terms of real GDP growth (when measured in change from the starting point), the scenario is comparable to previous EU-wide stress tests, but, as already said, less severe than the scenario for the postponed 2020 EU-wide stress test. The cross-country dispersion of shocks has declined

compared to previous years. However, when measuring severity in terms of deviation from the baseline, the 2021 scenario is in fact more severe than the 2020 scenario.

12. Is climate change risk considered in the scenario?

Climate risk is not explicitly considered in the scenario as methodologies to embed it in a stress test framework are still being developed. However, the EBA is currently carrying out a pilot sensitivity analysis on a sample of volunteering banks, in which EU corporate exposures are analysed in relation to climate risk. Some preliminary results of the exercise have been already published in a dedicated box of the [EBA Risk Assessment Report](#)³ while a more detailed and comprehensive report will follow during the first half of 2021.

Disclosure

13. How will data and results be published?

The credibility of the EU-wide stress test rests on transparency and one of the most important aspects of this exercise is the disclosure of a large amount of comparable and consistent data across the EU. The level of transparency will be comparable to the one that was planned for the 2020 exercise. The EBA will release bank-level data, aggregate reports and interactive tools. The transparency provided through such disclosure will enable market participants to determine how banks are dealing with remaining pockets of vulnerability.

Next steps

14. How will the stress test results feed into the SREP process and how will supervisors use these results?

The results of the stress test will allow CAs to assess banks' ability to meet applicable minimum and additional own funds requirements under the common downturn scenarios and assumptions. Furthermore, the results will form a solid ground for a discussion with supervisors and individual banks, in order to understand relevant management actions, such as how their capital planning, including dividend distribution, may be affected by the stress and, therefore, ensure that banks will remain above the applicable capital requirements, while continuing to finance the economy. Due to the specific macroeconomic conditions caused by the Covid-19 pandemic, the results of the 2021 EU-wide stress test might serve as valuable input to make informed decisions on possible exit strategies from the [flexibility measures granted to banks](#) due to the COVID-19 crisis, or on the need for additional measures, should the economic conditions deteriorate further.

15. What is the connection between the 2021 EU-wide stress test and the work on the future changes to the EU-wide stress test?

³ https://www.eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20Assessment%20Reports/2020/December%202020/961060/Risk%20Assessment_Report_December_2020.pdf

In parallel to the 2021 EU-wide stress test, the EBA will continue working to improve the current framework and will focus on further improving realism and efficiency of the exercise, maximising the information value of the results, and investigating further the role of top-down elements in the EU-wide stress test approach. The mentioned criteria were prioritised after a discussion on the received feedback on the [Discussion Paper on the future changes to the EU-wide stress test framework](#). As initially [communicated](#) at the end of July, a final decision on potential changes to the framework is still expected to be taken in Q2-Q3 2021, while the implementation of any potential change will be possible for the 2023 EU-wide stress test.